

No. 7/19/DPNP

Jakarta, June 14, 2005

C I R C U L A R L E T T E R

to

A L L C O M M E R C I A L B A N K S

I N I N D O N E S I A

Subject : Application of Risk Management for Banks Conducting
Activities Related to Mutual Funds.

In view of the steadily expanding involvement of Banks in activities related to Mutual Funds and in further implementation of Bank Indonesia Regulation Number 5/8/PBI/2003 dated May 19, 2003, concerning Application of Risk Management for Commercial Banks (State Gazette of the Republic of Indonesia Number 56 of 2003, Supplement to the State Gazette of the Republic of Indonesia Number 4292), furthermore in line with Bank Indonesia Regulation Number 7/6/PBI/2005 dated January 20, 2005, concerning Transparency in Product Information and Use of Customer Personal Data (State Gazette of the Republic of Indonesia Number 16 of 2005, Supplement to the State Gazette of the Republic of Indonesia Number 4475), it is deemed necessary to stipulate the implementation of risk management application for Banks conducting activities related to Mutual Funds in a Circular Letter of Bank Indonesia with the following key provisions:

I. GENERAL ...

I. GENERAL REVIEW

1. In response to the steadily expanding involvement of Banks in activities related to Mutual Funds, there is growing awareness that these activities not only yield benefits but also incur various potential risks for Banks, including market risk, credit risk, liquidity risk, legal risk, and reputational risk. In this regard, Banks need to strengthen the effective application of risk management through the implementation of prudential principles and protection of customer interests.
2. The scope of Bank activities related to Mutual Funds covers activities of Banks as investors, Banks as Mutual Fund Sales Agents, and Banks as Custodian Banks.

Activities of Banks as investors consist of Bank investments in Mutual Funds, including cases in which the Bank acts as sponsor. Sponsor is defined as the investment of a Bank in a Mutual Fund in the form of initial capital in an amount and tenor in compliance with the regulatory provisions of the capital market authority.

Activities of Banks as Mutual Fund Sales Agents are Bank activities for sale of Mutual Fund securities in the capacity of representing a securities company acting as Investment Manager, conducted by Bank employees licensed as Mutual Fund Sales Representatives for sale of Mutual Fund securities.

Bank activities as Mutual Fund Custodian Bank consist of Bank activities in operation of a collective depository, safekeeping and administration of Mutual Fund assets, administration/recording of changes in ownership of fund units, and other services including calculation of Net Asset Value, settlement of transactions, and receipt of dividends, interest, and other entitlements.

3. Banks conducting activities related to Mutual Funds are required to comply with the applicable banking and the capital market regulatory provisions.
4. To protect the interests of customers, Banks acting as Mutual Fund Sales Agents are required to ensure the application of transparency of product information through provision of written and verbal information.

II. APPLICATION OF RISK MANAGEMENT

A. Overview

1. The most important tasks that a Bank is required to perform in support of effective application of risk management are to:
 - a. ensure that any Investment Manager acting as partner in activities related to Mutual Funds is registered and licensed by the capital market authority in accordance with the applicable regulatory provisions;
 - b. ensure that the Mutual Fund concerned has received a statement of effective registration from the capital market authority in accordance with the applicable regulatory provisions;
 - c. identify, measure, monitor, and control risks arising from activities related to Mutual Funds.
2. In the implementation of prudential principles, Banks are prohibited from any action, whether directly or indirectly, that may cause a Mutual Fund to acquire characteristics resembling those of Bank products, for example, savings deposits or time deposits. The prohibited actions include but are not limited to:
 - a. provision of guarantee in respect of:
 - 1) redemption of Mutual Funds;

2) certainty ...

- 2) certainty regarding the level of yield of a Mutual Fund, including net asset value, whether directly or indirectly;
- b. entering into any commitment as standby buyer of the underlying reference assets of the Mutual Fund, whether directly or indirectly;
- c. intervening in portfolio management of Mutual Fund securities conducted by an Investment Manager.

B. Application of Risk Management for each Activity

1. Banks as Investors in Mutual Funds

- a. In accordance with Article 17 of Bank Indonesia Regulation Number 7/2/PBI/2005 dated January 20, 2005, concerning Assessment of Asset Quality for Commercial Banks, Banks are prohibited from holding Earning Assets in the form of shares and/or Securities linked to or guaranteed by underlying reference assets in the form of shares. Accordingly, Banks are prohibited from investing in Mutual Funds with underlying reference assets in the form of shares.
- b. When investing in a Mutual Fund, Banks are required to ensure that the investment complies with the applicable prudential provisions, including but not limited to:
 - 1) the requirement to take into account the financial capacity and condition of the Bank and the policy, strategy, and internal investment guidelines of the Bank;
 - 2) at the purchase date, the Mutual Fund must satisfy the criteria for rating as current in accordance with the

applicable ...

applicable regulatory provisions concerning Assessment of Asset Quality for Commercial Banks;

- 3) does not violate the Legal Lending Limit in accordance with the applicable regulatory provisions;
 - 4) is calculated into the minimum capital adequacy requirement taking account of market risk.
- c. To obtain assurance of the quality of a Mutual Fund classified current as referred to in letter b number 2), the Bank is required to conduct adequate analysis of the Mutual Fund and Investment Manager prior to engaging in activities as investor. This analysis shall cover:
- 1) quality (rating) of the Mutual Fund or quality (rating) of the underlying reference assets of the Mutual Fund;
 - 2) quality of the Investment Manager with emphasis among others on:
 - a) performance, liquidity, and reputation of the Investment Manager; and
 - b) diversification of the portfolio held by the Investment Manager.
- d. Banks are required to conduct regular monitoring of risk exposure from Bank activities related to Mutual Funds by monitoring the performance and management of the Mutual Fund and conducting assessment of the Investment Manager as follows:
- 1) monitoring of the performance and management of the Mutual Fund by the Investment Manager, including but not limited to:

a) consistency ...

- a) consistency of the Mutual Fund portfolio policy with the prospectus;
 - b) quality (rating) of the Mutual Fund or quality (rating) of the underlying reference assets of the Mutual Fund;
 - c) liquidity management;
 - d) public disclosure;
 - e) application of prudential principles in accordance with the regulations of the capital market authority.
- 2) assessment of the Investment Manager shall be conducted with emphasis on matters including but not limited to the following:
- a) performance, liquidity, and reputation of the Investment Manager; and
 - b) diversification of the portfolio held by the Investment Manager.

2. Banks as Mutual Fund Sales Agents

- a. Banks may only conduct activities as Mutual Fund Sales Agents through Bank employees licensed as Mutual Fund Sales Representatives in accordance with the applicable regulatory provisions. Such Bank employees acting as Mutual Fund Sales Representatives must be specifically designated by the Bank to act on behalf of and in the name of the Bank.
- b. Banks and Bank employees licensed as Mutual Fund Sales Representatives are prohibited from acting as Mutual Fund Sales Sub-Agents or to transfer the function of Mutual Fund Sales Agent to any other party.

c. To be ...

- c. To be sold by a Bank acting as Mutual Fund Sales Agent, a Mutual Fund must comply with the definitions and criteria stipulated in the applicable regulatory provisions concerning the Capital Market in Indonesia.
- d. Activities in the capacity of Mutual Fund Sales Agent shall be based on a written agreement clearly stating the functions, powers, and responsibilities of the Bank as Mutual Fund Sales Agent.

In preparing a written agreement of cooperation, the Bank shall take account of matters including but not limited to the following:

- 1) clarity of the rights and obligations of the respective parties;
- 2) clear stipulation of the duration of the agreement;
- 3) stipulation of a clause setting forth the conditions for cancellation of the agreement, including a clause enabling the Bank to terminate cooperation prior to expiration of the agreement;
- 4) clarity of settlement of the rights and obligations of the respective parties upon termination of the agreement;
- 5) in order to fulfill the obligation of the Custodian Bank to provide confirmation of customer investment, it is necessary to stipulate a clause on the obligation of the Mutual Fund Sales Agents to provide customer information and data to the Investment Manager and the Custodian Bank and a clause stating that all customer data may only be used for activities related to the Mutual Fund concerned.

- e. Banks are required to monitor the performance and management of the Mutual Fund and perform assessment of the Investment Manager as follows:
 - 1) monitoring of Mutual Fund performance and management of the Mutual Fund by the Investment Manager, including but not limited to:
 - a) consistency of the Mutual Fund portfolio policy with the prospectus;
 - b) liquidity management.
 - 2) assessment of the Investment Manager shall be conducted with emphasis on matters including but not limited to the following:
 - a) performance, liquidity, and reputation of the Investment Manager; and
 - b) diversification of the portfolio held by the Investment Manager.
- f. To protect customer interests, Banks are required to:
 - 1) conduct analysis in the selection of Mutual Funds to be offered, among others taking account of the performance, reputation, and expertise of the Investment Manager and characteristics of the Mutual Fund, such as the reputation of the parties acting as sponsors of the Mutual Fund, investment policy, composition, diversification, and quality (rating) of the Mutual Fund or quality (rating) of the underlying reference assets of the Mutual Fund;
 - 2) provide transparent information to customers in accordance with the applicable regulatory provisions concerning

Transparency in Bank Product Information and Use of Customer Personal Data.

- g. In providing transparent information to customers as referred to in letter f number 2), Banks are required to make complete and clear written information available in the Indonesian language and convey this information to customers in writing and/or orally. This information shall include but not be limited to:
- 1) Mutual Funds are a capital market product and not a Bank product, and the Bank shall not be responsible for any and all claims and risks arising from the portfolio management of the Mutual Fund;
 - 2) investments in Mutual Funds do not constitute part of the deposit funds of the Bank and do not come within the scope of the Government blanket guarantee or deposit insurance schemes;
 - 3) information on the Investment Manager managing the Mutual Fund;
 - 4) information on the Custodian Bank and an explanation that confirmation of the customer investment will be issued by the Custodian Bank;
 - 5) the nature of Mutual Funds and the risks inherent in Mutual Fund products include the possibility of loss of investment value to the customer as a result of fluctuation in Net Asset Value in accordance with market conditions and quality of the underlying reference assets;
 - 6) investment policy and portfolio composition;
 - 7) fees charged in regard to investment in the Mutual Fund.

h. Each ...

- h. Each document prepared by the Bank in relation to Mutual Funds shall state the following phrases clearly in easily legible form:
 - 1) “Bank in the capacity of Mutual Fund Sales Agent”;
 - 2) “Mutual Funds are a capital market product and not a Bank product and are therefore not guaranteed by the Bank and do not come within the scope of the Government blanket guarantee or deposit insurance schemes.”
- i. Banks acting as Mutual Fund Sales Agents are prohibited from issuing confirmation of investments placed by customers.
- j. In their activities as Mutual Fund Sales Agents, Banks are required to apply know your customer principles as stipulated in the applicable regulatory provisions.

In this regard, Banks are required to establish a know your customer policy and procedures for customers purchasing Mutual Funds, covering the following:

- 1) customer acceptance including enhanced due diligence for high risk customers;
 - 2) customer identification;
 - 3) monitoring of customer transactions;
 - 4) identification and reporting of suspicious transactions.
3. Banks operating as Custodian Banks
- a. Activities in the capacity of Custodian Bank shall be based on a written agreement. In preparing a written agreement, the Bank shall take account of matters that include but are not limited to the following:

1) clarity ...

- 1) clarity of the rights and obligations of the respective parties;
 - 2) clarity of settlement of the rights and obligations of the respective parties upon termination of the agreement;
 - 3) to satisfy the obligation of the Custodian Bank to provide confirmation of customer investment, it is necessary to stipulate a clause concerning the right of the Custodian Bank to obtain customer data from the Investment Manager and the Mutual Fund Sales Agent and a clause stating that all customer data may only be used for activities related to the Mutual Fund concerned.
- b. As stipulated in the regulatory provisions of the capital market authority, Custodian Banks are prohibited from being affiliated with an Investment Manager.
 - c. The Bank is required to maintain separate administration and records of the securities placed in its keeping, kept apart from the assets and liabilities of the Bank.
 - d. In issuing confirmation for customer investments, a Bank acting as Custodian Bank is prohibited from delegating its obligation to any other party, including to a Mutual Fund Sales Agent.
 - e. In the course of activities as Custodian Bank, a Bank shall apply the know your customer principles as stipulated in the applicable regulatory provisions.
 - f. If a Bank conducting activities as Custodian Bank also conducts activities as Mutual Fund Sales Agent, the Bank shall take action to obtain assurance of matters including but not limited to the following:

- 1) that it has in place and applies an effective system for internal control, including segregation of duties, among others ensuring that the officers and employees of a Bank functioning as Custodian Bank are placed in a unit separate from the unit functioning as Mutual Fund Sales Agent;
- 2) assurance of regular and ongoing verification and review of actions to address material weaknesses in activities as Custodian Bank and Mutual Fund Sales Agent and of actions taken to rectify any irregularities that may occur;
- 3) that it avoids conferring powers and responsibilities that may give rise to various conflicts of interest;
- 4) parties signing or validating the confirmation of customer investment are only from the Custodian unit of the Bank. In this regard, the Bank shall appoint and designate the officers and/or employees authorized to perform this task.

III. GUIDELINES FOR RISK MANAGEMENT

1. The application of Risk Management as referred to in number II shall be set out in written policy and procedures in accordance with Bank Indonesia Regulation Number 5/8/PBI/2003 dated May 19, 2003, concerning Application of Risk Management for Commercial Banks.
2. Any Bank conducting activities related to Mutual Funds and having a written policy and procedures concerning application of risk management in activities related to Mutual Funds although not fully in accordance with application of risk management as referred to in number II shall be required to bring itself into conformity concerning the policy, procedures, and activities related to Mutual Funds.

IV. PLANS ...

IV. PLANS AND REPORTING

1. As stipulated in Bank Indonesia Regulation Number 6/25/PBI/2004 dated October 22, 2004, concerning Commercial Bank Business Plans, the Business Plan of a Bank should state, among others, the development plan for new products and activities, including activities as Mutual Fund Sales Agent and/or Custodian Bank if the Bank is to conduct these activities.
2. Any Bank conducting activities as Mutual Fund Sales Agent and/or Custodian Bank for the first time shall submit a written report to Bank Indonesia no later than 7 (seven) working days after the activity is effectively launched in accordance with Article 25 of Bank Indonesia Regulation Number 5/8/PBI/2003 dated May 19, 2003, concerning Application of Risk Management for Commercial Banks, using the report format in accordance with Circular Letter of Bank Indonesia Number 5/21/DPNP dated September 29, 2003. This report shall present the following:
 - a. Operating procedures;
 - b. Organization and powers, including number of Bank offices conducting activities related to Mutual Funds and number of Mutual Fund Sales Representatives at each of these Bank offices;
 - c. Results of Bank identification of inherent risks;
 - d. Results from pilot testing of methods for measurement and monitoring of the inherent risks;
 - e. Legal analysis.
3. Any Bank already conducting activities as Mutual Fund Sales Agent and/or Custodian Bank shall submit a report on activities related to Mutual Funds each month for the end-month position, using the format in Appendix 1, no later than the 15th (fifteenth) day of the month after the reporting ...

the reporting month. In the first instance, this report shall be submitted for the position at the end of June 2005.

4. Any Bank already conducting activities related to Mutual Funds although not fully applying risk management as referred to in number II shall submit a report on measures for resolution of outstanding issues using the format in accordance with Appendix 2 no later than 1 (one) month after the promulgation of this Circular Letter of Bank Indonesia. The targeted time frame for resolution of outstanding issues shall be no more than 6 (six) months after the deadline for submission of the report.
5. Reports as referred to in number 2 and number 4 shall be submitted to Bank Indonesia at the following addresses:
 - a. the relevant Directorate of Bank Supervision, Jl. M.H. Thamrin No. 2, Jakarta 10110, for a Bank having its head office in the working area of the Bank Indonesia Head Office; or
 - b. the local Bank Indonesia Regional Office, for a Bank having its head office outside the working area of the Bank Indonesia Head Office.
6. Reports as referred to in number 3 shall be submitted to Bank Indonesia at the addresses referred to in number 5 with a copy to the Directorate of Banking Research and Regulation, c.q. Financial System Stability Bureau, Jl. M.H. Thamrin No. 2, Jakarta 10110.

V. MISCELLANEOUS PROVISIONS

1. To improve the effectiveness of risk management application, any Bank already conducting activities related to Mutual Funds shall be required to conduct an evaluation and audit of these activities in regard to compliance with application of risk management as referred to in number II.

2. If needed ...

2. If needed, Bank Indonesia may conduct examination of the effectiveness and suitability of risk management application specifically for activities conducted by the Bank in relation to Mutual Funds.
3. If a Bank markets Mutual Funds issued by an Investment Manager that is a subsidiary, the Bank shall also be required to apply risk management on an effective basis with reference to the regulatory provisions concerning Prudential Principles in Equity Participation Activities.
4. The Appendices referred to above constitute an integral part of this Circular Letter of Bank Indonesia.

VI. SANCTIONS

1. Any violation of the application of risk management as referred to in number II shall be liable to administrative sanctions, including but not limited to:
 - a. written warning;
 - b. freezing of specified business activities;
 - c. dismissal of Bank management,as referred to in Article 34 of Bank Indonesia Regulation Number 5/8/PBI/2003 dated May 19, 2003, concerning Application of Risk Management for Commercial Banks.
2. Any violation of the reporting requirements referred to in number IV.2 shall be liable to sanctions as stipulated in Article 33 of Bank Indonesia Regulation Number 5/8/PBI/2003 dated May 19, 2003, concerning Application of Risk Management for Commercial Banks.
3. Any violation of reporting requirements as referred to in number IV.3 and number IV.4 shall be liable to administrative sanctions, including but not limited to:

a. written ...

- a. written warning;
 - b. freezing of specified business activities,
- as referred to in Article 34 of Bank Indonesia Regulation Number 5/8/PBI/2003 dated May 19, 2003, concerning Application of Risk Management for Commercial Banks.

VII. CONCLUDING PROVISIONS

This Circular Letter of Bank Indonesia shall come into force on June 14, 2005.

For the public to be informed, it is ordered that this Circular Letter of Bank Indonesia be promulgated in the State Gazette of the Republic of Indonesia.

Kindly be informed.

BANK INDONESIA,

MAMAN H. SOMANTRI
DEPUTY GUBERNUR